

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200845028**
Release Date: 11/7/2008

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.
Telephone Number:

Index Number: 2601.00-00, 2501.00-00

Refer Reply To:
CC:PSI:B04
PLR-116475-07
Date:
July 24, 2008

Re:

Legend

Settlor =
Spouse 1 =
Son 1 =
Son 2 =
Son 3 =

Spouse 2 =
Spouse 3 =
Grandchild 1 =
Grandchild 2 =
Grandchild 3 =
Trust =

Trustees =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
State =
State Statute =
Agreement =

Dear :

This is in response to a letter dated March 9, 2007, and subsequent correspondence, from your authorized representative, in which you request rulings

concerning the gift and generation-skipping transfer (GST) tax consequences of a proposed settlement agreement.

FACTS

On Date 1, Settlor created an irrevocable trust, Trust. Date 1 is prior to September 25, 1985. Settlor died on Date 2, survived by Spouse 1, Son 1, Son 2, and Son 3. Spouse died on Date 3, and Son 1 died on Date 4 with no surviving spouse or issue. Son 2 is married to Spouse 2. Son 3 is married to Spouse 3 and they have three children, Grandchild 1, Grandchild 2, and Grandchild 3. All three grandchildren have attained age 21. Trustees are the current trustees of trust.

Section 2.01 of Trust provides that the net income is to be divided and distributed per stirpes among the Settlor's lawful descendants. Section 2.01 also provides that, if a son of the Settlor dies leaving a lawful surviving wife who has borne a child of his who had also survived him, or failing this, who was married to such son for a period of at least eight years at the time of such son's death, (referred to as a "qualifying wife") such qualifying wife shall be paid during her life, so long as she shall not remarry, one-third of the share of the net income that her deceased husband would be entitled to if living. Trust's net income is currently distributed to Son 2 and Son 3. Trust does not provide for distributions of corpus prior to termination.

Section 2.02 of Trust provides that upon the death of the survivor of Settlor, Spouse 1, Son 1, Son 2, and Son 3, Trust shall terminate at such time as all of Settlor's then living grandchildren have attained the age of 21 years, but no later than twenty-one years from the death of the last survivor of Spouse 1, Son 1, Son 2, and Son 3. On Trust's termination, the corpus of Trust is to be divided equally among Settlor's living descendants per stirpes. Currently, Son 2 and Son 3 are both over age 21 and are the sole current income beneficiaries of Trust.

Questions have arisen regarding the conflict between § 2.01 and § 2.02. Specifically, § 2.01 provides for the payment of trust income to a qualifying wife, for life or until remarriage. Section 2.02, however, requires termination of Trust within a specified period that may expire prior to the death of a qualifying wife. In order to resolve the conflict without litigation, the parties have reached a settlement agreement, the Agreement.

The parties have agreed that the provisions of § 2.02 should not be construed so as to terminate the income interest of a qualifying wife before such income interest would otherwise terminate by reason of the provisions of § 2.01. Accordingly, under the

Agreement, upon the death of the first to die of Son 2 or Son 3, survived by a qualifying wife, one-sixth of the Trust corpus will be distributed to a separate Widow's Trust. The Widow's Trust income will be paid to the qualifying wife until the first to occur of her death, remarriage or the expiration of the Trust's perpetuity period. On termination of the Widow's Trust, the corpus of that trust will be added to the "First Decedent's Family Trust" (discussed below) and/or distributed under the terms of that trust.

The "First Decedent's Family Trust" will also be established on the death of the first to die of Son 2 and Son 3, and will be funded with two-sixths of the Trust corpus. The income from this trust will be paid to the deceased Son's then living descendants, per stirpes, or if he has no living descendants, to his surviving brother as provided in § 2.01 of Trust. This trust will terminate on the death of the survivor of Son 2 and Son 3, at which time the corpus will be distributed outright per stirpes, to the descendants of the first deceased Son.

The remaining one-half of Trust corpus (that is, the portion not distributed to the Widow's Trust and the First Decedent's Family Trust on the death of the first of Son 2 and Son 3 to die) will continue to be held in Trust. The surviving Son will receive the income from this portion. On the surviving Son's subsequent death, survived by a qualifying wife, two-thirds of the remaining Trust corpus will be distributed outright per stirpes, to the descendants of the deceased Son. The remaining one-third of Trust corpus will be distributed to a separate Second Widow's Trust. The Second Widow's Trust income will be paid to the qualifying wife until the first to occur of her death, remarriage or the expiration of the Trust's perpetuity period. On termination of the Second Widow's Trust, the corpus of that trust will be distributed outright, per stripes, to the then living descendants the deceased Son.

Trust is governed by the laws of State. Under State Statute, an agreement among the primary beneficiaries of a trust and the trustee to construe any provision of the trust or an agreement regarding any duty, power or responsibility of the trustees, is final and binding on the trustee and all beneficiaries of the trust, both current and future, as if ordered by a court with competent jurisdiction over all parties, if the requirements of the Statute are satisfied. The term "primary beneficiaries" is defined as a beneficiary who is either (1) currently entitled or eligible to receive any portion of the trust income or principal, or (2) assuming nonexercise of all powers of appointment, will receive, or be entitled to withdraw, all or a portion of the principal of the trust, if the beneficiary survives to the final date of distribution with respect to the beneficiary's share.

Grandchild 1, Grandchild 2, and Grandchild 3 were represented by counsel separate from Son 2, Son 3, and Trustees. You represent that the terms of the Agreement were negotiated over several months and that no money or other property was exchanged between the parties as a condition to their entering into the Agreement.

You have also represented that there have been no additions to Trust after September 25, 1985.

The following rulings have been requested:

1. The implementation of the non-judicial Agreement construing the terms of Trust and setting forth the administrative mechanism for carrying out the Agreement will not cause Trust or any trust created thereunder pursuant to the Agreement to lose GST tax exempt status, or cause distributions from any such trusts to be subject to GST tax.

2. The implementation of the non-judicial Agreement construing the terms of Trust and setting forth the administrative mechanism for carrying out the Agreement will not result in a taxable gift by any party who has a present or future interest in Trust.

LAW AND ANALYSIS

Ruling Request 1 -- Generation-skipping transfer tax

Section 2601 imposes a tax on each generation-skipping transfer. Section 1433(a) of the Tax Reform Act of 1986 (TRA of 1986) provides that, except as provided in §1433(b), the GST tax applies to generation-skipping transfers made after October 22, 1986.

Section 1433(b)(2)(A) of the TRA of 1986 provides that the GST tax does not apply to transfers under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides that a trust qualifies for transitional rule relief from the provisions of Chapter 13, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under §26.2601-1(b)(1)(ii)(A), any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in a grantor's gross estate under §§2038 and 2042).

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST

tax purposes. Unless specifically providing otherwise, the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purpose of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to chapter 13, if (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the position of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Section 26.2601-1(b)(4)(i)(E), Example 5, describes a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The example concludes that the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to

the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

In this case, Trust was irrevocable on September 25, 1985. It is represented that there have been no actual or constructive additions to the Trust after September 25, 1985. Accordingly, Trust is exempt from GST tax under § 26.2601-1(b)(1). You represent that the Agreement is valid under applicable State law.

Based on the facts and representations, and assuming the Agreement is valid and binding under State law, the Agreement does not shift a beneficial interest in Trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the Agreement nor does the Agreement extend the time for vesting of any beneficial interest in Trust beyond the period provided in Trust. Therefore, based on the facts submitted and representations made, we conclude that the implementation of the Agreement construing the terms of Trust and setting forth the administrative mechanisms for carrying out the Agreement will not cause Trust or any trust created thereunder pursuant to the Agreement to lose GST tax exempt status, or cause distributions from any such trusts to be subject to the GST tax imposed by § 2601.

Ruling Request 2 -- Gift tax

Section 2501(a) provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(b) of the Gift Tax Regulations provides that, as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another, the gift is complete. But, if upon a transfer, a donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the fact in the particular case.

Section 25.2511-1(c)(1) provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes

depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. U.S., 674 F.2d 761, 774-75 (9th Cir. 1981), citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated.

The Agreement resolves the conflict between § 2.01 and § 2.02 of Trust and is reflective of the rights of the parties under applicable State law that would be applied by the highest court of State. Accordingly, based on the facts submitted and representations made, and provided the Agreement is valid and binding under State law, we conclude that the implementation of the Agreement will not cause any beneficiary who has a present or future interest in Trust to have made a taxable gift for purposes of the federal gift tax under § 2501.

The rulings contained in this letter are based upon information submitted and representations made by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

George L. Masnik
Chief, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter

cc: